

Internal Revenue Service
memorandum

CC:TL:Br3
SWianacone

date: [REDACTED]

to: District Counsel - Greensboro SE:GBO
Attn: Paul G. Topolka

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED] Statutory Notice of
Deficiency for the [REDACTED] Tax Year
Your ref: CC:GBO:TL-N-2795-[REDACTED]

This is in response to your memorandum dated [REDACTED], requesting formal technical advice concerning the issues listed below as well as our opinion and thoughts on proposed statutory notice language to be issued to the above-captioned taxpayers. We received your memorandum on [REDACTED], when it was transferred to us by Branch No. 4 of our Division which originally received it.

ISSUES

Whether contributions to an annuity plan in the aggregate amount of \$[REDACTED] are not excludable from gross income because; 1) it has not been established that an agreement, contract, or plan was in effect as required by I.R.C. § 403 and the accompanying regulations; 2) the contributions constituted an item of unreasonable compensation which inured to the personal benefit of the taxpayers in derogation of the contributor's exempt purposes; or, in the alternative, 3) if the aggregate amount contributed does qualify for purposes of I.R.C. § 403, the amount which may be excluded from gross income is limited to the lesser of the exclusion allowance computed under I.R.C. § 403(b)(2)(A) or the limitation imposed by I.R.C. § 415(c) for the limitation year ending with or within the taxable year.

CONCLUSION

For the reasons discussed below, we believe that the issues have been properly presented in the proposed statutory notice language and that it is appropriate for issuance with some minor technical corrections.

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DISCUSSION

The basis for that portion of the statutory notice that you have asked us to review is a contribution in the aggregate amount of \$ [REDACTED] made by the [REDACTED], an exempt organization, to the [REDACTED] on behalf of [REDACTED] for the taxable year [REDACTED]. Since your office is of the opinion that the Commissioner cannot deny the annuity exclusion based upon a "proposed" revocation¹/ of the exempt status of [REDACTED], you have sought to deny the the annuity exclusion for the reasons as set forth in your draft statutory notice language.

As noted in the Revenue Agent's report, the Form W-2 issued by [REDACTED] for [REDACTED] for the [REDACTED] calendar year was for total wages of \$ [REDACTED]. This amount did not include any of the contributions made by [REDACTED] to the benefit fund on behalf of [REDACTED]. During the examination of [REDACTED], a request was made for a copy of the agreement, contract, or other evidence with respect to amounts contributed to the benefit fund by [REDACTED] on behalf of [REDACTED]. No such agreement or other evidence to show that an agreement was in effect has been presented in response to that request.

I.R.C. § 403(b) provides that:

(1) GENERAL RULE.--If--

(A) an annuity contract is purchased--

(i) for an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a), or

* * *

then amounts contributed by such employer for such annuity contract on or after such rights become

nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the exclusion allowance for such taxable year.

Treas. Reg. § 1.403(b)-1(b) provides:

(1) In general. If amounts are contributed by an employer during a taxable year of an employee . . . , toward the purchase for such employee of an annuity contract . . . , then, to the extent such amounts do not exceed the exclusion allowance for such taxable year, they are not required to be included in the gross income of such employee for such taxable year, if at the time of contribution--

(i) The employer is an organization described in section 501(c)(3) and exempt from tax under 501(a),

* * *

(3) [T]he exclusion provided by this paragraph is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary, or to forego an increase in salary, but only to the extent such amounts are earned by the employee after the agreement becomes effective. Such agreement must be legally binding and irrevocable with respect to amounts earned while the agreement is in effect.

Since there has been no evidence presented to establish that there was an agreement or contract in place or in effect, as required by the Code and regulations, the requirements for exclusion from income pursuant to these above-mentioned sections have not been met. Therefore, none of the contributions made by [REDACTED] to the benefit plan on behalf of [REDACTED] for the [REDACTED] tax year may be excluded from income.

In addition, after discussions with a representative of Branch No. 4, it would appear that the contributions to the annuity plan made by [REDACTED] constitute an item of unreasonable compensation which inured to the personal benefit of [REDACTED] from the net earnings of [REDACTED] in derogation of its exempt purposes. Thus, [REDACTED] was not entitled to this amount of compensation and it was not "earned" in accordance with I.R.C. § 403 and the accompanying regulations.

With respect to your alternative position, if [REDACTED] is determined to be a qualified employer at the time of the contributions and the amounts contributed qualify for

purposes of I.R.C. § 403, then an amount may be excluded from income. This amount is limited to the lesser of the exclusion allowance computed under I.R.C. § 403(b)(2)(A) or the limitation imposed by I.R.C. § 415(c) for the limitation year ending with or within the taxable year.


Since there has not been sufficient information supplied from which the exclusion allowance under I.R.C. § 403(b)(2)(A) can be computed, for the [REDACTED] tax year the limitation under I.R.C. § 415(c) is the lesser of 25% of a participant's compensation for the year, or \$30,000.00. In light of [REDACTED]'s W-2 wages, the maximum amount which he may exclude from gross income under this provision is \$30,000.00.

Finally, we would recommend minor changes to the language of the statutory notice that you have forwarded for our inspection. In the heading, "Other Income - Annuity Payments by Employer," we believe you should substitute the term "Contributions" for "Annuity Payments." These are terms of art and using annuity payments where you in fact mean contributions could create confusion. We recommend the same language change for the body of the notice. Instead of "annuity payments" in the first line, "contributions to the annuity plan" should be inserted. Also, at the beginning of the second sentence, "contributions" should be substituted for "annuity payments."

If we can be of further assistance please contact Steven W. Ianacone at FTS 566-3407.

MARLENE GROSS
Director

By:


DANIEL J. WILES
Chief, Branch No. 3
Tax Litigation Division